Internal Revenue Service
memorandum

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date: DEC 13 1991

to: Barry A. Scheland, Regional Technical Coordinator
Southwest Region

from: William P. O'Shea, Chief, Branch 3, Office of Assistant Chief Counsel (Passthroughs and Special Industries)

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subject: Technical Coordination Report 17,917 (91-125) - (A request to amend section 1372 to eliminate an apparent inequity in the fringe benefit area).

We want to thank William R. Sothen, Revenue Agent, for his recommendations to amend section 1372 and to revoke Revenue Ruling 71-588, 1971-2 C.B. 91. We carefully reviewed his proposed changes to section 1372 and his proposal to revoke Rev. Rul. 71-588, and we do not agree with the recommended changes. We are aware of what appear to be inequities in the tax treatment of employee fringe benefits for partners, S corporation shareholders, and C corporation shareholders. The apparent inequities in the tax treatment of employee fringe benefits result from the type of entity (partnership, S corporation, or C corporation) in which taxpayers choose to do business.

A taxpayer's choice of entity for doing business involves evaluating certain tax benefits or burdens for each type of entity. Partnerships and S corporations receive certain federal income tax benefits, such as, no tax at the partnership or corporate level, and partners and S shareholders get an immediate deduction for losses. An S corporation also retains many of the benefits of operating in the corporate form, such as, limited liability and free transferability of share interests. Before choosing to do business in the form of a partnership or before electing S corporation status, however, partners and shareholders should consider all legal and tax aspects of the election because there can be certain disadvantages involved for federal income tax purposes.

Congress enacted subchapter S to minimize the effect of Federal income taxes on a taxpayer's choice of entity for doing business. In addition, Congress wanted to permit incorporation and operation of certain small businesses without incidence of income taxation at both corporate and shareholder levels. Moreover, one purpose of the Subchapter S Revision Act of 1982 was to make the tax treatment of S corporations more like the tax treatment of partnerships. S. Rep. No. 97-640, 97th Cong., 2d

Sess. (1982), 1982-2 C.B. 718, 719-720; H. Rep. No. 97-826, 97th Cong., 2d Sess. (1982), 1982-2 C.B. 730, 731-732.

Since the 1982 Act, S corporations and partnerships generally receive similar tax treatment as passthrough entities. Unlike C corporations, partnerships and S corporations are not considered taxable entities for federal income tax purposes. The income of the S corporation passes through to shareholders who pay tax on such income in a manner similar to the passthrough of income to partners. Thus, the federal income taxation of S corporations generally parallels the tax treatment of partnerships. The parallel tax treatment of S corporations and partnerships includes the taxation of fringe benefits. Both S corporation shareholder-employees and partners are required to include certain fringe benefits in their income.

Furthermore, Congress' intent in changing the tax treatment of employee fringe benefits for more than 2-percent S corporation shareholders in the Subchapter S Revision Act of 1982 was to create an equity of tax treatment for 2-percent shareholders and partners. As added by the 1982 Act, section 1372(a) of the Internal Revenue Code provides that for purposes of employee fringe benefits, the S corporation shall be treated as a partnership, and any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership. Under prior law concerning employee fringe benefits, S corporations were treated more like C corporations, and S corporation shareholder-employees were allowed to exclude certain fringe benefits from income. This was unlike partners who never have been treated as employees, and never have been allowed to exclude certain fringe benefits from income.

Rev. Rul. 91-26, I.R.B. 1991-15 I.R.B. 23, holds that accident and health insurance premiums paid or furnished by an S corporation to or for the benefit of its 2-percent shareholder-employees in consideration for services rendered are treated for income tax purposes like partnership guaranteed payments under section 707(c) of the Code. An S corporation is entitled to deduct the cost of such employee fringe benefits under section 162(a) if the requirements of that section are satisfied.

Like a partner, a 2-percent shareholder is required to include the value of such benefits in gross income under section 61(a), and is not entitled to exclude such benefits from gross income under provisions of the Code permitting the exclusion of employee fringe benefits (except to the extent the Code provision allowing exclusion of a fringe benefit specifically provides that it applies to partners). Provided that all of the requirements of section 162(l) are met, however, a 2-percent shareholder may deduct the cost of the premiums to the extent provided by section

162(l) (currently, 162(l), expiring December 31, 1991, provides for a deduction of 25-percent of the cost of the accident and health insurance premiums).

Rev. Rul. 71-588, 1971-2 C.B. 91, holds that amounts received by employees of a sole proprietor (including the employee-spouse of the sole proprietor) as reimbursements for medical expenses incurred are excludible from their gross incomes pursuant to section 105(b) of the Code and are deductible by the sole proprietor as a business expense under section 162(a).

The sole purpose for Rev. Rul. 71-588 was to clarify that the family relationship does not affect the employee's exclusion or the sole proprietor's deduction. Rev. Rul. 71-588 does not interpret a confusing or unclear statute. Rather, it simply states a conclusion that would be obvious were it not for the family relationship.

The Service no longer withdraws revenue rulings, but it does revoke them. The "Definition of Terms," which appears in recent Cumulative Bulletins and current Internal Revenue Bulletins, defines "revoked" as describing situations in which the position in a previously published ruling is not correct and the correct position is being stated in a new ruling.

We do not believe the position in Rev. Rul. 71-588 is incorrect. Furthermore, we are unaware of any statutory provision or Supreme Court decision that would affect the conclusion of the revenue ruling. Moreover, in the absence of Rev. Rul. 71-588, we are unaware of any basis for arriving at a conclusion other than that in the revenue ruling.

Section 162(a) of the Code allows a deduction for the ordinary and necessary expenses paid or incurred in carrying on a trade or business. An ordinary expense is one that is customary and usual within a particular trade, industry, or community. A necessary expense is generally one that is appropriate and helpful rather than essential to a taxpayer's business. <u>See</u> <u>Welch v. Helvering</u>, 290 U.S. 111 (1933). Whether an expense is ordinary and necessary is largely a question of fact.

To be considered ordinary and necessary, an expense must be reasonable in amount. <u>Commissioner v. Lincoln Electric Co.</u>, 176 F.2d 815 (6th Cir. 1949), <u>cert. denied</u>, 338 U.S. 949 (1949). Whether an expense is reasonable is also largely a question of fact.

Both Rev. Rul. 91-26 and Rev. Rul. 71-588 allow a deduction for business expenses under section 162(a) if the requirements of that section are satisfied. To satisfy section 162(a), the expenses must be ordinary and necessary, and to be considered ordinary and necessary must be reasonable in amount. Unreasonable expenses, such as the medical expenses listed in the TCR, should be challenged as not satisfying section 162(a).

In conclusion, we believe that comparison of the tax treatment of employee fringe benefits should be between similar entities like partnerships and S corporations rather than comparing passthrough entities with C corporations. The manner in which partners and S corporation shareholders are taxed is different than the manner in which a C corporation and its shareholders are taxed. S corporations combine the flexibility of a partnership format with the advantages of operating in the corporate form. Because S corporations are hybrid business entities taxed generally like partnerships, comparison of the tax treatment of fringe benefits for partners and S corporation shareholders with C corporation shareholders to determine who receives the greatest tax advantage is not appropriate.

Attached are five copies of this memorandum. Please furnish copies of the memorandum to appropriate persons, including the originator, Mr. Sothen. In addition, please thank Mr. Sothen for his interest in the employee fringe benefit area and for taking the time to research and analyze what he believed to be an unnecessary tax inequity among partners, S corporation shareholders, C corporation shareholders, and sole proprietors. We appreciate his time and effort.

Attachments: 5 copies of this memorandum